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Introduction

Rural (and to a lesser degree urban) finance forms nowadays one of the key concepts of development planning.[1] Identifying undercapitalization on the grassroots level as one of the main development impediments, access to capital has been considered as a means for development. At least until the 1970s economic growth and income growth were assumed to depend on the growth of factor inputs, of which capital input was treated to be the most important variable. Underdevelopment was considered to result from the 'vicious cycle of poverty'.[2] The only possibility to induce growth was seen by providing capital from outside sources. This capital was spent on technological improvements bought in the donor or lender countries in exchange for capital goods such as machinery. The planning concepts of the period aimed at a top-down capitalization, with major investment in the technology of large- and medium scale industries and commercial agriculture (production techniques, land reforms, marketing facilities, etc.). Eventually, it was assumed, smaller and small-scale enterprises as well as off-farm activities should profit from 'trickle-down' effects and a gradual spill-over of techniques, and the population should benefit from employment in the growth sectors.

In retrospective it is commonly agreed that this one-sided development strategy was too narrow and wrong in its basic assumptions. During the 1970s it became obvious that unintended counter-effects emerged, too, such as an increased dualism of the economy and society, poverty, unemployment, and land flight. The following development decade therefore changed the emphasis. The new strategy which was introduced by the UN/ILO, was the fight against poverty with a basic-needs and target group-orientation. In other words, the access to cheap credit on the grassroots level was identified as a necessary condition for development. Although the target groups were different, finance

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[1] For a good summary of development finance until the 1990s, see Krahnen and Schmidt (1994).

[2] It was argued that the poverty of individual and public households results from low incomes, so that savings cannot take place which are necessary for investment. This again results in low productivity and low income, i.e. in poverty.

was still considered capital provision from outside sources, now to farmers and small businesses instead of formerly big enterprise and public institutions. The economic rate of return as the measure for success, which included macro-economic and public benefits such as health, employment, education, external effects, and so on, replaced the formerly used financial rate of return. Specialized subsidized development banks and programs were introduced to distribute credit. However, the success of these banks with respect to reaching the target groups was poor. Reasons were identified as ranging from economic limitations on the lenders' side, such as high transaction costs and risk involved, to causal limitations on the borrowers' side, such as high opportunity costs, inadequate bank's opening hours, time-consuming credit application procedures, non-adaptation to borrowers' credit requirements, resentments of customers because of the depersonalization of credit relations, and so on. Although an efficient operation of these institutions was not required by development policy, the default rates were so high that they were beyond toleration, very often accounting for more than 90 percent (see, for example, Adams et al. 1984). This has caused the development planners to shift their focus again. The main problem identified now are institutional impediments. The current approaches aim at higher efficiency, stability and autonomy of the existing and the development of new financial institutions. The policy applied will lead to the creation of self-perpetuating local income flows (the mobilization of the savings of the target group) to form a basis for the lending of the institutions involved, to make them independent from government subsidies.

Many development planners hold the black-and-white view that Third-World economies and financial markets consist of a modern and a traditional sector. It is assumed that the latter impedes development mainly for two reasons: the charging of exorbitant interest and the provision of consumer credit which does not generate higher future income to the borrowers and leads to increasing indebtedness. That matters are not so simple has been shown by various studies. The high interest rates are in many cases a result of high transaction costs, risk involved, and lender's opportunity costs (see, for example, Singh 1983 and Schrader 1994b), and a clear-cut distinction of production and consumer loans is difficult from the perspective of the household. Indeed, banks have certain advantages compared to informal lenders, such as the readiness to finance long-term and large-scale loans, to offer additional services such as consultancy, to be refinanced by the state bank, and so forth. However, informal lenders have certain comparative advantages, too. As they belong in many cases to the *Lebenswelt* (life-world) of their customers, they have good information and therefore low transaction and monitoring costs and the borrowers have low transaction and opportunity costs. Bor rowing procedures are simple. There is personal knowledge of lender and borrower and no fixed office hours, and the borrower can go to see the lender under cover of night to avoid gossip in the village. Even the smallest credit can be obtained, and the repayment is adapted to the requirements of the borrower.

To overcome the financial dualism, four strategies have been suggested. One is the ‘upgrading’ of semi-formal financial agents and institutions to use the advantages of particular informal lenders (know-how and closeness to borrowers), another is the ‘downgrading’ of banks. A third one is the linking of formal banks with self-help groups to use peer monitoring (i.e. group-internal pressure to borrowers) as a means of reducing the risk of lending. A fourth approch that has been called '*institutional innovation*' refers to an implementation of particularly member- or communaliy directed financial institutions (see, for example, BMZ et al. 1987; Seibel 1989a,b; Krahnen and Schmidt 1994; Seibel 1996). Some politicians engage in heavy state interventionism to eliminate certain informal suppliers; some experts again rely on market forces to bring down the informal interest rates. The result of these options is the same. The dualism will be overcome in such a way that informal finance disappears eventually.

Definitions

<u>Finance</u>[3] is the monetary and inter-temporal decision aspects of economic processes. It comprises everything which involves saving, lending (credit) and the insurance of financial risks. Credit is therefore one component of finance only. The <u>financial infrastructure</u> includes all savings and financing opportunities and institutions which provide saving and credit facilities, as well as the valid norms and modes of behavior related to the financial system, i.e. political, legal, moral, etc. <u>Financial agents</u> may or may not be institutionalized and/or specialized on financial services or even particular financial services. <u>Financial landscapes</u>[4] are the broad spectrum of financial markets, financial agents and their clients (borrowers) and the financial infrastructure.

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[3] The definitions of finance, financial infrastructure and financial intermediary are in line with the definitions of the BMZ et al. (1987). The other definitions have been supplemented by the author.

[4] The term ‘financial landscapes’ was suggested on the Wageningen Conference on ‘Financial Landscapes Reconstructed’, 17-19 November 1992, to replace the dual terms ‘formal’ and ‘informal financial sectors’. It indicates the broad spectrum of financial agents. The analysis of the structure of particular financial landscapes can be considered to form maps of these landscapes.

A term which has been commonly used for the description of financial landscapes is a dual approach (Kessler et al. 1985) which is analogous to the formal and informal sectors of the real economy: formal and informal finance and formal and informal financial sectors, respectively.[5] Following Germidis (1990), the formal financial sector of developing countries is subordinated to policies ranging from total regulation with extensive government control and intervention in the activities of monetary institutions (with the effect of hindering the development of financial markets, [Polak 1989]) to a higher degree of liberalization, of decision-making at the institutional level, and of market forces. It is obvious that the structure of the formal sector to some degree determines the extent of the informal sector, yet the informal sector has a certain dynamic of its own. One line of argument considers the informal financial sector to be a response to the shortcomings of the formal financial sector and therefore supplementary, the other line considers financial dualism to be a mirror of the economic dualism of developing countries, both sectors having been interpreted as being hardly related to each other. Reality, however, shows that the informal financial sector provides credit not only to those who have no access to formal credit at all, but that many borrowers combine formal and informal credit sources, or even use their access to formal banks or credit programs to obtain credit and on-lend to informal borrowers. Policy-makers consider financial dualism dangerous for the development of the economy, as it conserves sectoral and regional disparities (for example, capital-intensive - labour-intensive or urban - rural) and an unequal division of income, due to the fact that informal credit is more costly for the borrower. Furthermore, informal structures undermine the government’s economic, monetary and fiscal policies.

The common critique of the concept of formal and informal real sector can be applied here, too. These categories should be used descriptively rather than analytically, and the boundaries of both sectors are not at all clear-cut (see Elwert, Evers and Wilkens 1983). The older line of argumentation, the perception of non-overlap of both sectors (but not the dichotomy formal-informal) has recently been overcome with the question of linkages between both sectors. This linkage has always existed, after the emergence of

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[5] Another dualistic terminology that has been used analogously is ‘organized’ versus ‘unorganized finance’ (see, for example, Tun Wai 1980).

formal finance, through financial intermediaries. This term is applied to financial agents who are linked in one way or the other to both financial sectors or, to put it another way, those who have access to formal finance with formal incomes and savings or formal credit which they on-lend informally.

The Structure of Financial Landscapes

A common definition applied to formal and informal financial markets is very techno-cratic:

> "Financial markets (not institutions) are defined here as formal when they fall under the control of the state credit and of related financial laws (...).[6] For formal financial institutions the government, or state, usually es-tablishes a central bank as an instrument of central control. Consequently, financial markets are defined as informal when they operate outside such control" (Kropp et al. 1989: 27).

Another, to my mind more useful, definition has been recently provided by Krahnen and Schmidt (1994). They start from the realistic assumption of imperfect markets in which information is distributed asymmetrically. To obtain and maintain good informa-tion on the borrower (monitoring) is costly for the lender. Particular enforcement mechanisms of repayment may compensate for imperfect information.

> "There may be different types of enforcement mechanisms: social sanc-tions between members of a community, or a family, for instance; or an illegal, possibly violent form of prosecution by a gang; or legal prosecu-tion through official agents like policemen or sheriffs.
>
> To give an example, loan arrangement can be supported by formal collat-eral if in case of non-fulfillment of contract terms the lender has the right, and indeed the practical opportunity, to liquidate the pledged asset. Here, the right and its enforceability are crucial. The same collateral will be of little use if the creditor is unable to execute his claim.
>
> A lack of enforceability using legal means, however, is characteristic of informal transactions. Social sanctions and norms, or moral or family ties might then substitute for legal enforcement (...) Apart from social and ethical norms, the absence of legally enforceable contractual stipulations

[6] For other scholars, the fact that they fall under the control of the state is more de-cisive.

> induces economic agents to develop an intelligent contractual form that diminishes the risk of breach of contract by anyone party to the arrangement (...)
>
> A more precise definition of formal and informal economic activities can now be developed: A transaction between economic agents is called formal if for enforcement purpose it relies on the legal system of society. Otherwise it is called informal” (Krahnen and Schmidt 1994: 33).

To introduce a legal infrastructure, Krahnen and Schmidt (1994) continue, is quite expensive. Such a legal infrastructure in most developing countries therefore exists for specific economic activities or agents only. The other way around, most people cannot rely on the legal infrastructure. Either they cannot enter legal contracts for reasons of access and cost or such contracts do not give them security. Informality is thus characterized by a lack of legal infrastructure. This lack is compensated by longer-term inter-temporal relationships between the transacting parties. The time between the performance of one party and counter-performance of the other requires an explicit or implicit form of bonding such as the pledging of fields, crops, labour and life or the potential loss of social standing and honor. In certain cases such informal bonds are even stronger than laws such as the still existing - although prohibited - bonded labour in India. Another form of informal control is ‘peer-monitoring’, i.e. social control within a group which is positively correlated with group homogeneity of kinship, sex, age, ethnic membership, profession etc. Certain informal financial institutions such as rotating savings and credit associations and ‘strategies’ such as the linkage-concept which will be discussed later, make use of peer monitoring.

Worth noting is the plural form ‘markets’, which scholars mostly apply. This form shall refer to the different, in many cases not integrated, segments of financial markets (the imperfection of the market system with only limited mobility of capital flows from one segment to the other, different interest rates and borrowing conditions in different markets, limited information on the conditions in other markets, limited access etc.), which is true for many developing countries.

Among the broad distinguishing features of formal and informal financial markets which Kropp et al. (1989) list, are the following (exceptions exist of course): (a) Formal financial markets are highly centralized. Decentralization depends on the branches of the centralized institutions. Informal financial markets are atomized, with many different agents/institutions. (b) Both markets operate rather independently from one another, with different agents/institutions, clients, modes of operation, interest rates etc. (c) The target group of the formal market is the upper stratum of the population, such as formal sector employees and enterprises, including state institutions. However, many formal sector workers are nevertheless excluded from access. Informal financial markets are accessible to both upper and lower strata but mainly used by the lower strata of the population: rural and urban informal sector participants. Semi-formal institutions serve, in general, the better off of the lower strata. (d) Access to credit in the formal financial sector is handled much more restrictively than access to deposit accounts and this again much more than to saving accounts. The informal credit, deposit and saving possibilities form the only opportunity of access for the informal target group. (e) Both markets have certain strengths and weaknesses:

> “(...) formal financial markets excel in modernity, in access to national and international refinancing institutions and in access to other supporting institutions, none of which applies to informal financial markets. Informal financial markets excel in accessibility, popular participation, basic needs orientation, organizational flexibility, local adaptability, situational appropriateness and sociocultural integration at the local or regional level, none of which applies to formal financial markets. (... On the other hand, H.S.) formal financial markets comprise a powerful modern sector with the potential of contributing to the dynamic growth of the economy, but are limited to a few - and therefore are unable to initiate self-sustained development. Informal financial markets are open to all; but they comprise a weak indigenous sector, contributing mainly to survival through self-help and to slow development on the local level” (Kropp et al. 1989: 30-1).

The share of formal and informal finance with respect to both number of people involved as well as volume varies form one country to another. Nevertheless, various case studies reveal that both volume of informal finance and number of people involved exceed at least 50 percent in most Third-World countries (Pischke, Adams and Donald 1983), although the relative and probably also absolute shares have decreased during the last three decades. Nevertheless, their share reflects the financial viability and adaptability of informal finance to their clients’ needs and the cultural gap between most formal financial institutions and many customers.

Considering the average level of nominal interest charged by informal agents and institutions it has declined from 40 percent in the 1950s to 30 percent in the 1970s with large deviations, but is still higher than formal interest rates. However, the gap between average formal and informal interest rates has narrowed during the past decades (Tun Wai 1980: 260).

Germidis (1990) provided the following cross-cultural estimates of the share of formal finance, approximated by the ratio of market capitalization to domestic credit.[7]

Tab. 1: Market Capitalization as Percentage of Domestic Credit in Selected Countries

Year	1981	1982	1983	1984	1985	1986	1987*
India	15.10	13.30	7.60	12.30	15.60	15.60	14.10
Indonesia	1.10	3.10	2.50	0.90	0.80	0.60	0.60
Philippines	10.60	6.50	7.10	6.20	12.10	24.40	26.70
Thailand	6.10	6.90	6.30	6.20	7.40	10.30	14.80
Zimbabwe	29.00	16.00	14.30	12.10	28.00	27.10	41.30
Nigeria	11.70	4.70	7.90	8.00	7.60	4.10	
Mexico	11.70	2.20	5.40	6.20	6.30	10.70	31.50
Brazil	17.80	13.40	22.60	49.90	61.40		

Source: International Monetary Fund 1989: International Financial Statistics 1988. Note: * Estimates

Formal Financial Markets

Unlike the informal financial markets, the formal ones have been well documented.[8] The major formal institutions comprise the central banks, commercial or business banks, development banks, savings banks, cooperative banks, merchant banks, building societies, and the insurance and social security sector. Licensed investment companies, hire-purchase companies, public pawnshops (and sometimes private licensed ones) and so on may also be part of formal financial markets. Financial markets of their own form the capital markets (financial, bond and stock markets) which, depending on the country, are more or less developed. Formal financial institutions operate in a

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7 This ratio reflects the relative weight of market mechanisms versus intermediation mechanisms as well as the private sector in the economy.

8 In the description I follow Kropp et al. (1989). Recently a valuable comparative study on informal finance in Asia was published by the Asian Development Bank (Ghate 1992).

commercial way such as commercial banks, or in a non-commercial way, such as subsidized government credit programs.

The traditional role of the central bank is that of a monetary control agency. In some countries such as Indonesia, it acts furthermore as a development bank, which plans, monitors and evaluates development programs that are implemented by executing banks or non-banking institutions.

Commercial banks provide the services of savings and non-risky credit, trade shares and obligations, and do certain own businesses. In many developing countries they have been obliged to reserve a certain percentage of their lending budget for small entrepreneurs and farmers. Nevertheless, they work with the bigger clients only among this target group. It is not so much the risk involved than the high transaction costs for small-scale lending, with credit ceilings below market rates, that discourage banks from supplying the small-scale credit needed by small-scale traders, peasants, craftsmen, and so on.

Many development banks limit their activity to credit transactions with particular target groups and economic sectors and have run into difficulty because of poor repayment rates, scarce national and international credit lines and sometimes internal problems. Some have therefore extended their activity to savings and deposit transactions for small enterprises.

Savings banks, like post office saving banks work with the target group of small savers. They provide the service of savings only. Critics hold against such institutions - and this was indeed the cause of their initial establishment during the colonial period - that they drain away capital from the poor periphery of countries into their centers and raise a disposable fund for the government. Due to high inflation rates in many Third-World countries, which in many cases exceed the savings interest rates (negative real savings), the tendency to hold savings accounts has decreased.[9] As a consequence of this some of these banks were transformed into savings and credit banks.

Cooperative savings and credit institutions are formal or semi-formal institutions such as credit unions, *banques populaires* or *caisses rurales*. In Germany they go back to

[9] The author carried out a quantitative, comparative pilot study on the financial structure of banks in developing countries, particularly in Asia (see Schrader 1993).

Raiffeisen and Schulze-Delitz and developed toward the end of the nineteenth century as a reaction to decreasing rural welfare, while in Britain, for example, this movement was associated with the Rochdale Pioneers. However, in most developing countries these institutions have been introduced from above. Many cooperatives fall under the cooperative law rather than under financial laws, especially if they are multi-purpose cooperatives. Among the financial cooperatives, two categories - the savings-based and the credit-oriented organizations - have to be distinguished.

What has been summarized as the main strengths and weaknesses of formal financial institutions. These strengths are:

- they provide modern services;
- they can finance long-term and large-scale businesses;
- they collaborate with national and international partners and have access to refinancing and other supporting institutions;
- they are integrated into the formal and public sector.

The main weaknesses are the following:

- they only reach a small number of small-scale enterprises, they are spatially and psychologically distant from informal small enterprises in particular and exclude them from their services;
- they ignore socio-cultural, socio-political and socio-economic conditions.

Informal Financial Markets

Informal financial individual agents[10] and institutions are usually grouped as non-commercial and commercial ones. In many cases they offer the financial service of lending only. However, again it is difficult with some agents to place them in one or the other category. Friends and relatives, for example, are usually considered to belong to non-commercial agents because they are expected to provide credit without aiming at

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[10] Kropp et al. (1989) distinguish a third category: semi-formal financial agents which comprise government organizations and private voluntary, or non-government, organizations backed by international organizations or by bilateral support. They act like formal financial institutions but they do not fall under the credit law or under direct or indirect central bank supervision. But they are more than tolerated by the state which happens to most informal financial agents and institutions. Data reveal that once such institutions exceed a certain size, they become formalized.

profit.[11] What, however (as I observed during research), if somebody provides credit to his brother bearing 20 percent interest per month? Is such a loan non-commercial because of the closeness of social relation, commercial because of the high interest or even usurious? I assume in line with Mauss (1925) that non-commercial loans are not necessarily altruistic as commonly assumed. I consider them in the tradition of structural functionalism as an investment into social security under the aspect of future reciprocity. Commercial financial agents are then all those who aim at profit. Because of the difficulty to identify clear-cut boundaries Germidis (1990) added another category: the semi-commercial agent, which to my mind does not solve the problem. I suggest to take into consideration, the primary motivation of loan provision through lenders. Nevertheless a categorization according to this scheme should be avoided. Those who take profit from lending in one or the other way have often been named 'moneylender', which will be discussed in the following paragraph and analyzed in greater detail. The literature on India exhibits a category distinct from the moneylender, which has been called the 'indigenous banker', who is similar to the medieval merchant banker in Europe (vgl. Schrader 1994, 1995).

Moneylenders

The terms 'moneylending' or 'moneylender' used in the literature are catch-all terms. Unlike most scholars, some (for example, Kropp et al. 1989) use the terms in a very narrow sense (purely professional lender of cash only). As will be seen, however, such a definition does not make sense, since most informal individual lenders combine commerce in one or another way with lending, so that a very loose use of the terms seems appropriate to me. I do not confine moneylending to monetized transactions only, but shall apply it to transactions in kind or a combination of cash and in kind transactions, too. What is - strictly speaking - a contradiction in terms, makes nevertheless sense with regard to the business of moneylenders. **Credit (or loan) is then the lending of cash or kind, to be paid back after a period of time in cash, kind, or in a combination of both, with or without interest.**

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[11] The criterion taken is either very narrowly confined to non-interest arrangements or to the profit orientation of the lender because in many cases friends and relatives obtain compensation for their cost. The latter seems more appropriate to me.

Such a broad definition allows us to include a variety of functions that cannot be explained by a single monolithic model of economic theory alone, but comprises additional sociological and psychological factors, too.

From the perspectives of anthropology and sociology it is useful to count the lending of non-monetary objects such as commodities, non-commodified goods of prestige or sacred circulating (like in the *kula* or the *potlatch*),[12] and even services such as labour, help, etc. among credit. Many informal financial transactions are somewhat embedded in personal social relations and therefore more complex as is assumed by most economists. In addition to economic conditions they can comprise invisible elements of open or hidden social benefits and obligations, such as patron-client relationships, bonded labour, and so on.

The same is, of course, true for the question of interest that will be discussed later. Here it is sufficient to emphasize that in complex credit relations the level of interest may be irrelevant or even unknown, and that the calculation of an interest rate may be misleading in many cases, since in many transactions no direct relation exists between the duration of the loan and the interest rate. In embedded financial transactions social functions of credit provision may cover and modify the economic ones or even replace them. In such transactions the social goal of credit relations may be either to create dependencies (see, for example, Sahlins 1972: 208) or to establish or maintain interdependencies. Another fact which has been overlooked by many economists is that, in applying a macro-view on all credit transactions within a village, the distinction between borrowers and lenders in a particular setting often makes no sense, since most villagers are borrowers in some relations and lenders in other ones, or the position may change in time (see, for example, Harriss 1983; Jones 1994).

From a theoretical point of view there is of course a qualitative difference between cash and in kind transactions. However, assuming that moneylenders aim for profit, they have to do both cash and in kind transactions (and a combination of both), and this not only in incompletely monetized rural regions, but in every rural context. In many transactions in kind interest rates remain hidden, and some extra profits can be achieved by exploiting periodical price differences before and after the harvest. In this sense I

[12] Here I refer to Malinowski (1964) and Mauss (1925). For a structure-functional interpretation of the gift as a credit transaction, see Chapter 3.

understand moneylenders in a very loose sense: as lenders who aim for profit.[13] However, this is an insufficient criterion in a number of cases at least. One can argue with Rothermund (1982: 17) that moneylenders aim at creating continuous dependencies. To put it another way, it is not the recovery of the principal sum but a continuous flow of interest *because* the principal sum was not repaid, that is the strategy of many moneylenders. The category of moneylenders include thes following sub-categories: professional moneylenders,[14] i.e. pure lenders, and semi-professional moneylenders, i.e. those lenders, who combine commerce with lending. Professional moneylenders are fewer in number than semi-professional ones. Among the latter the profit motive does not necessarily correspond to high interest. Here the motive of creating dependencies makes sense in a way that lending may also provide a means of acquiring produce cheaply (this is, for example, the case with advances on the harvest by crop dealers, or production inputs on credit by input-output merchants), it may provide a means to secure deliveries, or it may primarily aim at maintaining or acquiring new customers (as in the case of shops). In any case, moneylending is hidden behind the facade of a shop or a commercial office. I want to emphasize that the history of moneylending (and indigenously developed banking, too) is indispensable from trade. However, commerce-cum-moneylending does not provide the only category of semi-professional moneylending. This type of moneylender belongs per definition to the sphere of non-producers. Landlord-lenders are another typical category of individual informal lenders.

[13] ’Profit’ will be used here in a narrow economic sense as the difference between turnover and costs. ‘Costs’ will include transaction costs and opportunity costs, too. ‘Transaction costs’ are the sum of providing a loan and collection costs, administrative costs, cost attributed to payments of loans and default costs. The simple relation exists that the smaller the credit, the higher the transaction costs as a percentage of the loan sum because this cost component can be assumed to be fixed and becomes less important with the loan size. ‘Opportunity costs’ are the potential profit, which could have been realized with another investment alternative.

[14] This definition in the sense of the occupational structure of statistics inhibits the problem that moneylenders' legislation and the licensing of professional moneylenders may cause professional moneylenders to conceal this activity behind other professions. Another choice might have been to take the time spent with moneylending. Here again the question is what is the unit of reference, the individual or the family? In some cases the husband is an employee in the formal sector, while his wife is a ‘housewife’ working as a moneylender. Is she then a professional lender? To take the share of contributing to the household income as the distinguishing feature is difficult, too, with respect to civil servants or professionals whose official salary may be rather low, but whose professional status is high.

Most of them are not only rentiers in the Marxian sense (i.e. non-producers), but may run some commercial agriculture based on hired labour, too. Another non-producing contemporary category of semi-professional moneylenders are professionals and government servants (or more precisely: their wives), who prefer to 'invest' in moneylending rather than taking their savings to a bank account, since the returns of the former choice are higher. It should be emphasized here that the savings have been derived from formal incomes, while they are on-lent informally. Or, due to their regular salaries they have access to formal credit which also can be onlent with higher interest. From such a perspective this type of lenders belongs to the financial intermediaries. It can even be said that petty moneylending can be done by everybody who has some savings,[15] be they cash or in kind.

Excluded from the category of moneylenders are (according to my perspective) friends and relatives (of whom many do not aim for profit) and pawnshops. The reason why the pawnshop forms a category apart is that it is - strictly speaking - an agency based not on the provision of credit but on a purchase of an under-priced good with the temporary right of the former owner to re-purchase it at a higher price, the price difference being interpreted as an interest rate. Again, however, a clear-cut boundary of this category is difficult to apply. In many cases at least the moneylender-cum-trader (and to some extent indigenously developed banker-cum-merchant) takes collateral from the borrower to obtain better credit security, which may range from physical objects to land and real estate titles.[16] The latter, which are not taken into physical possession by the lender, are not pawns but mortgages. I see the institution of the pawnshop, be it public or private, as distinct from that of the moneylender because it provides the particular service of purchase with a re-sale option. In many countries the running of private pawnshops requires a license, while in some countries even government monopolies exist.

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[15] In the Chinese empire, for example, no particular moneylenders class probably existed. Everybody who had some capital functioned as a lender. At the turn of the century a missionary reported that "the whole Chinese empire may be said to be in a perpetual state of borrowing and lending, and a large majority of its people are daily concerned with that most practical question of how they shall pay the interest to the minority who have lent them money" (quoted by Skinner 1976: 23). To my mind, such a bottom sphere of moneylending has been and can still be found in most developing countries. It may be headed by certain classes, castes or occupational groups, which are not necessarily pure lenders but belong to the class of non-producers.

[16] For rural India, Bouman (1989), for example, used the terms 'moneylender' and 'pawnbroker' interchangeably.

A small paragraph on pawnshops follows later. Whether pawnshops belong to formal, semi-formal or informal financial markets, and are run in a commercial or non-commercial way, depends on the financial and civil laws. The same may hold true for licensed professional moneylenders.

Town moneylenders are sometimes pure lenders, but more often traders-cum-lenders. Many of them operate individually, others through a number of branches and agents. These operate in part with their own, in part with foreign capital. The smaller urban lenders provide primarily consumption loans, while the bigger ones operate in the same way as merchant bankers financing trade and commerce. Most of these advances are short-term to finance the transport of goods, and this type of lender usually ascertains the reason for which the loan is required. Loans are predominantly in cash. Deposits are rarely accepted. The default rates among these bigger town moneylenders are said to be low. After the introduction of moneylenders' legislation the number of licensed moneylenders has gradually increased. There is no clear-cut boundary to indigenous-style bankers.

It is not uncommon for small-scale traders to make deposits with 'mobile bankers', as reported from Africa (Miracle, Miracle and Cohen 1980). To avoid confusion with indigenous-style bankers I name them 'savings collectors', visiting their customers regularly on market days to collect the savings. They keep one deposit per period as their fee and return the rest in a lump sum at the end of the period. In other words: Savers obtain no savings interest, but they pay the savings collector for the service of safekeeping. This form of saving provides the benefit to customers that these savings are secure from theft in their homes, from moral claims of family members to redistribute them and from the own incapability to save individually and make a monthly budget plan. In some cases such savings collectors may also extend credit to depositors. Many of these are probably agents of town moneylenders aiming merely at raising working capital for short-term loans.

Prejudices against moneylenders are founded on their charging exorbitant and exploitative interest rates (and in some cases this is certainly true), that they sometimes offend against religious morality (particularly of Islam), that they are not interested in the use of credit, so that the loan is often for consumption/luxury purposes and counter-productive for rural or national development, and that it induces dependency. Development policy further relates moneylending to rural backwardness. Additionally, personalized relations with clients make it difficult for development planners to incorporate moneylenders into modernization programs. This may explain the aim of most planners to eliminate moneylenders who are considered to prevent the acceptance of formal and semi-formal financial institutions among the population (Pischke, Adams and Donald 1983: 229).

The World Bank studying formal and informal institutions in 1983 concluded it is not uncommon that such political attitudes depreciate

> "the functional role that informal lenders play during the incipient development of rural financial markets and may result in policies which displace informal lenders without offering alternate sources of institutional credit (...) In these circumstances, rather than substitutes for these formal arrangements, formal arrangements can and should complement these arrangements, supplement and strengthen informal credit sources, and compete with informal lenders" (World Bank 1983: 48, quoted by Kropp et al. 1989: 40).

Trade Credit

In many cases the dualistic structure of real markets is associated with a modern urban, industrial and commercial sector which is related to formal finance, and a traditional rural sector related to informal finance. This is not the case in reality, as urban studies reveal, but these have so far been neglected because of their small number. It is not only that urban commerce is largely financed by informal agents, but the urban industrial sector is highly imperfect, too. Only large-scale firms have access to banks, while the majority of medium- and small-scale enterprises have to rely on informal finance. One category of credit in the industrial and commercial sectors is trade credit. With such credit arrangements the creditor (an input supplier or a manufacturer) transfers on credit non-financial physical resources to the debtor (processing enterprise, wholesaler, retailers, or middleman). The debtor is not a consumer. He uses the physical credit either as an input for production or as items for sale to other traders or consumers. Such trade credit is usually short-term, and the transferred resources are used as part of the working capital. Together with savings and credit associations, trade credit can be considered as a sort of self-financing of particular groups/branches with similar interests.

It is typical of Third-World industrial production that customers do not immediately pay cash, i.e. they obtain trade credits. Lamberte and Jose (1988) found for the footwear industries of the Philippines that 84 percent of sales to customers take place on credit with a maturity between 30 and 60 days. This is not merely a matter of a friendly advance, but rather small manufacturers in particular are forced by bigger wholesalers or retailer to extend them trade credits which use to be secured in most cases by post-dated checks. In some cases the interest is hidden because cash payments obtain a bonus. In other cases the prices set for trade credit arrangements are visibly slightly higher than for cash payments. Most producers have to borrow themselves or apply for trade credit because a great part of their working capital is bound up in trade credit extended to customers. The scholars identified long credit chains ranging from department stores and supermarkets to manufacturers and input suppliers. While these credit chains are all found within the informal financial market, there are probably some linkages to formal finance, too.

Pawnbrokers and Pawnshops

In the villages and towns pawning is a daily affair. Anyone in need of quick cash pledges some valuables either to a private or public pawnshop, or provides a pawn as collateral to the pawnbroker-moneylender. As found by the Asian Development Bank (Ghate 1992) for the Philippines, and this also holds true for several other countries, individuals of even modest means use pawn brokerage as an additional income source.

Pawnbrokers and pawnshops estimate the value of the pawn and provide a certain percentage of the value to the customer. As already mentioned, from the theoretical point of view a pawn agreement is not a loan from the pawner’s side but a sale under value with the right to repurchase (this is also true for mortgage loans). Pawnbrokers and pawnshops provide important financial intermediaries. They supply ready cash without long procedures to primarily low-income groups and often have been called ‘financial institutions for the poor’. They seem to successfully handle small-scale lending and the problems related to it. For example, the transaction costs as a percentage of the loan sum are expected to be very high in small-scale operations in general and for the storage of pawns in particular. However, this can be compensated to some extent. Not every article is accepted as a pawn. Preferential pawns are small with high value because the storage cost is lower for such pawns. Pawnbrokers or pawnshops have no information costs on the borrower nor monitoring costs on the loan because the payment for the pawn covers a percentage of its value only. Therefore the risk involved in pawn brokerage is not the default of the pawner, which is compensated by the value of the pawn, but the incorrect pricing of the pawn by the pawnee or the taking into pawn of stolen items which, depending on the national laws, have to be returned to the original owner. Whereas pawn brokerage is widespread among a variety of informal lenders who take movable collateral into pawn as a security for the loans, pawnshops are institutions which confine themselves to the financial service of pawn brokerage only.

Considering the history of pawn brokerage, it is probably as old as property.[17] According to Skully (1994), the establishment of pawnshops as specialized institutions is, however, another affair. In Asia the pawnshop is probably older than in Europe, where such institutions emerged in Italy around 1000 AD. Like the first Italian pawnshops, the Chinese ones, probably the oldest in Asia, had a religious connection, and they did initially not aim for profit but had a charitable character. Chinese scholars found no interest mentioned. The gradual shift towards interest seemed to present no moral problem as it did in Europe. Early Chinese pawnshops seemed to be the reverse to the current ones. They hired out goods and animals, such as ploughing utensils and oxen, which belonged to the Buddhist monastery. To reduce the risks, pledges and third-party guarantors soon were required. Then a third change took place to arrive at what constitutes the contemporary pawnshop: the acceptance of goods, although this acceptance was related to safekeeping in the early phase. The Chinese pawnshops were privatized in 600-900 AD. From the fourteenth until the seventeenth century private pawnshops flourished in almost every town, city and many villages.[18] In other Southeast Asian countries (Malaysia, Thailand, Singapore) the history of pawnshops seems to be closely connected with Chinese merchants.

In Malaya, Indonesia, Thailand and the Philippines pawnshops seem to have been farmed out long before the Europeans arrived. Dutch and British colonial practice took over revenue farms. In Singapore the government revenues from pawn brokerage were not very profitable compared to other licenses and farms (1824: pawn brokerage: $ 480; gambling: $ 26,112; opium: $ 23,100; spirits: $ 10,980). In Thailand and Hong Kong pawnshops go back to the nineteenth century, while local pawnbrokers are much older.

In time private pawnshops began to be condemned as usurious by the European population in the colonies. In the Netherlands Indies first experiments with public pawnshops date back to 1746. The pawnshop development in Thailand is similar to

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[17] Even the Bible refers to pawns (Exodus, chapter 22, verse 25: ‘his clothes as a pledge of his repayment’).

[18] By the early 1800s, 25,000 pawnshops were reported for China.

Indonesia, with a shift from private to public pawnshops. In 1985 King Rama V introduced the first pawnshop act,[19] which gave legal status to these institutions.[20] In 1955, in competition with private pawnshops, government pawnshops were introduced, which charged lower interest rates and gave a higher valuation of the pawn. In 1962 the Pawnshop Act of BE 2505 was enforced.[21] Nowadays public and private pawnshops still coexist, whereas private pawnshops are not allowed outside Bangkok and new registrations have been forbidden since 1978. Public pawnshops are again divided into federal government institutions and municipal ones.[22] Public pawnshops cover their costs. Since both public and private pawnshops in Thailand are strongly regulated, Sujariyapinum (1988) counted them as formal finance.

In contemporary Malaysia, the Philippines, and Singapore the pawnshop industry is exclusively private, in China we can find private and cooperative pawnshops, and in Indonesia officially only government pawnshops. Interest rates are regulated. They range from only 1.5 percent per month in Singapore to 3-4 percent for public pawnshops in Indonesia,[23] and from 3.6 percent for public pawnshops to 9 percent for private pawnshops in Thailand.

The number of pawnshops per country varies considerably: in 1990 Indonesia counted 505 and Thailand 361; in 1991 Malaysia counted 194 and Singapore 60. Common

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[19] As early as the Ayudhya period, already, a first law to regulate pawn brokerage was introduced, but it served more the pawnbroker than the customer. Night pawning was outlawed, and the pawnbroker and customer had to know each other personally to single out thieves from normal customers (Thakranonthachai 1982).

[20] Pawnshops had to register, obtain a license which had to be renewed every month, and pay a fee of Baht 50. Maximum interest rates were also fixed; however, pawnbrokers circumvented this regulation by taking a 5 percent service charge. The person in charge of the licensing of pawnshops had the name of *Praya Indrathipbodeesiharajrongmuang*. Due to the monthly fee many pawnshops continued illegally. By 1936 there were 88 legally registered pawnshops (Thakranonthachai 1982).

[21] All pawnshops under the regulatory control of the Registration Division which specified working hours, operation procedures, maximum interest rates, and so on (Thakranonthachai 1982).

[22] A very detailed account on pawning behavior in Bangkok has been provided by Sujariyapinum (1988). In the mid-1980s, 219 of around 330 pawnshops operated in Bangkok.

[23] That is to say, three percent per month for loans smaller than Rp 20,000, 4 percent for loans larger than Rp 20,000.

pledges in more advanced countries, such as Malaysia, Singapore and the Philippines were almost exclusively gold and jewelry, in Thailand electronics in addition to gold and jewelry, while in Indonesia a variety of household articles are pledged, too. Pawnshop owners prefer gold and jewelry because gold prices tend to rise consistently. The cash offered as percentage of value amounts to at least 30 percent in the Philippines (fixed by the government) to normally around 75 to 85 percent for gold and jewelry in Thailand (75-85 percent) and in Singapore (80-85 percent), while in Indonesia the government provides 84 percent for loans less than Rp 20,000 and 89 percent for loans more than this amount.

In India, as contained in the report of the Study Group on Indigenous Bankers (1971: 21ff.), pawnbrokers offer 70 percent of the value of gold ornaments and 50 percent in the case of silver. As the value of the pawn exceeds the loan by far, bad debts are rare. The boundaries between moneylender and pawnbroker are vague. In Madras Marwari pawnshops largely finance the small-scale vegetable trade. The vegetable vendors tend to pledge their jewels and clothes in the morning to obtain a small-scale loan of Rs 5 to 20 as working capital to buy their stock. The interest rate ranges from 1 to 2 paise per day, and the borrower pays interest and principal in the evening. This procedure is repeated the next morning. In 1943, the State of Tamil Nadu introduced the Tamil Nadu Pawnbrokers Act, according to which a pawnbroker is required to maintain certain books and is not allowed to take more than the simple interest of 12 percent per year (which amounts to one paisa per rupee per month). In spite of this strict regulation, the number of licensed pawnbrokers shows that this business is profitable.[24] Loans on ornaments and valuables range from 7.5 to 18 percent (7.5 to 12 percent in the case of gold), on jewelry 10 to 15 percent, on silver 18 percent per annum.

To sum up, pawnshops are either run by the government, by the municipality, or privately. In most Southeast Asian countries pawn brokerage requires a license. Whether pawnshops fall into the formal, semi-formal or informal financial market, and whether they can be considered commercial or non-commercial, depends on the particular financial and civil laws.

[24] In 1969 this state issued 7,364 renewal licenses and 1,425 new licenses (SGIB 1971: 21).

Savings and Credit Associations

It is commonly agreed that originally savings and credit associations were self-help emergency funds.[25] Nowadays savings and credit associations are found all around the world and among all parts of the population. In recent times, the majority of these associations have become pure financial institutions with the secondary function of insurance business. Many of them have been commercialized, too, being started or run by merchants, managing firms and even banks for the sake of profit, while the aspect of self-help has been totally lost. The various forms of savings and credit associations to my mind do not allow us to categorize them as commercial or non-commercial institutions. Nevertheless, most of these institutions are autonomous and therefore counted as belonging to informal finance. Most scholars agree that the participation in a savings and credit association may, at least to some extent, keep away low-income households from moneylenders.

The main distinction of savings and credit associations is between RoSCAs and ASCrAs, the rotating and the non-rotating, accumulating savings and credit associations, respectively.[26] The emphasis of each association may be on the savings or credit side. The recent discussion of RoSCAs and ASCrAs shows that a shift has taken place from the less calculable RoSCAs to the more calculable ASCrAs.

Recent Approaches to Development Finance

Nowadays scholars agree that subsidized credit programs have not fulfilled the assumption that subsidized interest rates induce more investment and produce more socio-economic justice. The reasons for the failure are the following. First of all, investment and savings are closely interrelated. However, low fixed lending rates also result in low savings rates which not only do not provide an incentive to open a bank savings account but it may result in more attractive investment opportunities for potential savers, such as

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[25] Seibel and Marx (1987: 15) even assumed that work associations are a basic form of savings and credit associations, which are found in less monetized regions and are organized in a similar way. In various cases they are combined with a savings and credit fund.

[26] For a recent discussion of RoSCAs, see Schrader (1991); Pischke (1992), Bouman (1994).

informal moneylending and pawn brokerage. Second, financial repression has a negative impact on the quality of investment. Market rate lending singles out high-risk projects and those with very low returns. Third, interest ceilings for credit and credit rationing resulting from high demand for cheap credit may have counter-effects such as bribery, nepotistic lending, and so on. In addition to the negative effects on savings, investment, growth and distribution, subsidized credit may prevent the banking system to fulfill one main function, namely to collect idle money and to make it available for deficit households and enterprises. Low or even negative profit margins prevent the realization of economies of scale, so that only the larger customers obtain bank credit (a large part of transaction costs are fixed costs), while the majority of people has neither access to bank loans nor, in many cases, to deposit accounts (see Krahnen and Schmidt 1994).

A micro-economic reason for the failure of subsidized credit programs has been overlooked by most development planners. It seems to me that this is only due to their limited investigation of the borrowers' side and the concentration on the lenders' side. The reason for this is simply that low-income households not only combine different income sources to make a living but different credit sources, too. Under such an assumption, the risk that a borrower defaults in the subsidized credit program is the highest for two reasons. (a) Assuming that a borrower acts rationally he will repay the costly loans (i.e. the moneylender) first and the cheap ones last. (b) Assuming the 'safety-first' principle (Scott 1976) a borrower is more likely to be reliable in his long-standing credit line with his moneylender than in an unproved impersonal though cheaper credit line. Also economists have realized that the credit demand among the poor population is highly inelastic to interest rate changes. This may explain the high default rates in subsidized credit programs.

The failure of subsidized credit programs has supported the assumption that, instead of considering the lack of capital as the primary development impediment, the financial system has to be reorganized. This means taking the whole spectrum of financial services into consideration. As a reaction to interventionism and regulation of finance, and with the decline of Keynesanism, the neoclassical faction among development planners recaptured the strongest position. Among them, the approach developed by the Ohio State University-circle around D.W. Adams achieved prominence. This approach considers the unrestricted financial market to be an efficient allocator of financial services. It recommends the deregulation of financial systems and leaving the rest to market forces. Only such systems, it is argued, will be able to mobilize savings, transform them into investable funds and channel these funds into socially valuable investment projects. Indeed, in recent years deregulation has been achieved in various countries of East and Southeast Asia.

Krahnen and Schmidt (1994) rightly criticized the ‘Ohio State University Approach’ in that it has not been theoretically grounded. The argument is mainly based on a critique of prevailing development policy. The implicit model being used is that of monolithic, profit-maximizing financial institutions which function in the same way as commodity markets (Stieglitz 1989). Krahnen and Schmidt held against this approach that deregulation alone does not solve the problems. They adhere to ‘New Development Economics’ (Stieglitz 1986) that is based upon New Institutional Economics. This view assumes that economic development depends to a high degree upon the availability of ‘good institutions’, a prerequisite of which is a good financial sector. Institutions, it is argued, are good if they provide incentives for savings, capital accumulation and allocation in such a way that they induce growth. (The term ‘institution’ is used in a broad sense. It includes markets, firms and governments, the financial system and its main elements). Krahnen and Schmidt held against deregulated financial markets that they do not only function in a non-optimal way but that they do not function at all. The reason for this is that credit and capital rationing can be expected in deregulated markets. Financial agreements in everyday life include elements which express the dangers of particular credit relations. This view assumes that financial markets are important, but they are imperfect in nature. The main issue is to analyze which institutions function in what way on the basis of what information. The existing institutions are considered to be the result of a long-term competitive and selective process. However, because of the imperfection of the financial market, the existing institutions do not function in an optimal way. Nor is the market allocation which these institutions take over optimal. This view is open for interventions which improve the allocation of resources.

The supporters of institution-building of course assume that financial reform programs have to be placed within a broader context of structural adjustment programs. With variations from one country to another, structural adjustment typically covers four areas: (i) macro-economic reform of the monetary, fiscal and exchange rate regimes and trade liberalization; (ii) real sector reform; (iii) legal, institutional and political reform; and (iv) financial sector reform. The latter comprises the following components: (a) the rehabilitation of banks through financial and organizational measures; (b) deregulation and liberalization; (c) the strengthening of bank supervisory institutions; (d) the limitation of government powers with respect to regulation; (e) the lowering in entry and exit barriers of the banking sector (Krahnen and Schmidt 1994).

The three strategies for institution-building pursued until now by development planners are ‘upgrading’, ‘downgrading’ and ‘linking’. Institutions concerned in these approaches are institutions from the formal and informal financial sectors which are not financial institutions in the legal sense. One side consists of NGOs (non-government organizations), PVOs (i.e. private voluntary organizations), self-help groups and other informal-sector groups, donor-initiated rotating funds and credit programs, cooperative-type organizations, and so on. This side is assumed to be close to the grassroots level but the institutions lack professionalism, have high operational cost and tend to be short-lived. The other side consists of banks and similar institutions of the formal financial sector which are considered to be distant from the grassroots level, but operate efficiently and are relatively stable.

The strategy of ‘downgrading’ banks relies on these attributes and aims at moving them closer to the grassroots level. ‘Upgrading’ relies upon the closeness of informal and semi-formal financial institutions to the grassroots level and seeks to make them more efficient, professional and stable. Some development experts try to ‘link’ the advantages of both types of institutions. For example, a bank will provide funding to an NGO which on-lends for its own projects, or a bank may cooperate with informal groups which will distribute or collect funds and acts as a guarantor for credit security through collective responsibility or peer monitoring (see, for example, Seibel 1989a,b; 1990).

Among other arguments Krahnen and Schmidt (1994) held against these strategies that the planners consider the institutions to be already in existence. The introduction of an institution or new type of institution, as well as the reconstruction of an existing institution are also important. The only objective was to improve the social and economic situation of the target population (target-group orientation). This depends upon two factors, namely the presence of a political, institutional and economic environment, and the policy and structure of the particular financial institution. On the operational level sustainability is equally important: a target group-oriented institution has to be professional and financially and organizationally stable and efficient. Development policy, it is claimed, has to shift the emphasis from financial support to technical assistance. Target group-oriented institutions should provide the following services: deposit or savings facilities, credit or borrowing facilities, payment transfer services and risk management and insurance services.

Institutional analysis and institution-building are to my mind a useful tool of development finance because this approach takes a broader perspective compared to the earlier ones, starts from the realistic assumption of imperfect financial markets and considers the strengths and weaknesses of particular financial institutions of both financial sectors and their ways of coping with situations such as risk. However, the weakness of this approach and of most approaches by development planners is that they largely ignore the perspective of the borrowers and confine themselves to particular institutions only - a perspective which results from the professional profile and economic training of development experts. However, a misconception of the borrowers' side may lead to erroneous assumptions in institution-building. Furthermore, the approach implicitly assumes that existing institutions and agents - be they formal or informal - do not work efficiently enough and have to be re-organized in one or the other way to fit in with the market or even be replaced. In most cases, too, economists leave the historical perspective out of consideration. What they overlook is that certain 'indigenous' financial agents and institutions have emerged in particular historical periods in relation to particular requirements of the economy and its actors. Over time some of them disappeared and others developed; others again have adapted themselves to changing circumstances and the requirements of the borrowers, which points to at least some efficiency of those who have survived. Institution-building is thus a long-lasting process which has been at work for some time, and is not merely a recent phenomenon. This process has produced the contemporary financial landscapes. To my mind, the multiplicity of agents and institutions cannot be explained by a period of transition of the developing economies in which old, inefficient agents and institutions are eventually replaced by newer, more efficient ones.

This multiplicity is a reflection of the different conditions and requirements of the population with respect to financial services. This means that formal and informal finance are somehow interrelated, be this relation competitive in some cases, or complementary in others. Such differences therefore require a perspective which assumes a different suitability and efficiency of agents and institutions for different target groups and the different requirements of such target groups in the financial markets. Let us take, for example, rotating savings and credit associations. From the economic point of view of undercapitalization impeding economic growth, one disadvantage of RoSCAs is the limited amount of money the participants have in turn available. However, subjectively considered, i.e. from the perspective of the single member, this disadvantage may be unimportant, if the amount covers his needs. Also RoSCA members may themselves determine which type of RoSCA they consider most appropriate for themselves. Those who require larger and more liquid funds may take part in larger RoSCA of the auctioning type. Similar subjective considerations from the point of view of borrowers are necessary to explain why certain types of commercial lenders have survived. For many borrowers the immediate availability of money is more important than the level of interest. They may even prefer a long-established credit line with high interest to new lending programs which have been institutionalized from above. Moreover, many small-scale borrowers can only exist on the basis of day-to-day small-scale credit which they use as their working capital and which banks cannot provide at reasonable rates because of the high fixed cost component. In spite of the high interest rates of such informal loans (if one calculates them annually), the productive input of the loan provides the borrowers with a sufficient income to make a living.

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